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JAMES R. BROWNING

No. 710

In the Supreme Court of the United States

OCTOBER TERM, 1960

UNITED FINANCE AND THRIFT CORPORATION OF TULSA, ETC., ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

ARCHIBALD COX,
Solicitor General,

LOUIS F. OBERDORFER,
Assistant Attorney General,

HARRY BAUM,
SHARON L. KING,
Attorneys,
Department of Justice,
Washington 25, D. C.

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OPINIONS BELOW

The opinion of the Tax Court (R. 49-63)[1] is reported at 31 T.C. 278. The opinion of the Court of Appeals (Pet. 1a-7a) is reported at 282 F.2d 919.

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[1] "R" refers to the separate appendix to the petitioners' brief in the Fourth Circuit.

JURISDICTION

The judgment of the Court of Appeals was entered on September 29, 1960. Rehearing was denied on November 14, 1960. (Pet. 8a.) The petition for a writ of certiorari was filed on February 10, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the record supports the findings of both courts below (1) that the price paid by taxpayers for the intangible assets of two loan companies was attributable partly to depreciable covenants by the sellers not to compete and partly to non-depreciable good will; and (2) as to the portion of the price allocable to each.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * *

(l) [as amended by Sec. 121(c), Revenue Act of 1942, c. 619, 56 Stat. 798] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

> SEC. 39.23(l)-3. *Depreciation of intangible property.* Intangibles, the use of which in the trade or business or in the production of income is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises. Intangibles, the use of which in the business or trade or in the production of income is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business or in the production of income for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. No deduction for depreciation, including obsolescence, is allowable in respect of good will.

STATEMENT

These consolidated cases involve deficiencies in income taxes arising from the disallowance in part of depreciation deductions claimed by the taxpayers. The facts as found by the Tax Court (R. 51-58), some of which were stipulated (R. 37-41), are as follows:

On November 1, 1950, the United Finance and Thrift Corporation of Tulsa County ("the taxpayer")

executed an agreement whereby it purchased the loan accounts of the Tulsa office of the Royal Loan Company for $181,803—the full unpaid value of the purchased notes—and paid an additional sum of $23,397 as the expressed consideration for Royal's covenant not to compete. (R. 52-53.) For tax purposes, the taxpayer immediately began amortizing the sum of $23,397 on its books as a deductible item accruing from a depreciable covenant not to compete. (R. 57; Pet. 4a.)

On October 7, 1952, the taxpayer executed a similar agreement whereby it purchased the loan accounts of the Tulsa office of the Bankers Investment Company for $26,125.54—the full unpaid value of the purchased notes—and paid the additional sum of $4,750 as the expressed consideration for Bankers' covenant not to compete. (R. 54-55.) For tax purposes the taxpayer immediately began amortizing the sum of $4,750 as attributable entirely to the covenant not to compete. (R. 57; Pet. 5a.)

On October 10, 1952, the taxpayer assigned to United Finance and Thrift Corporation of Tulsa (hereinafter sometimes referred to as the assignee-taxpayer) the remaining balances of the loan accounts purchased from Royal and the unamortized cost attributed to Royal's covenant not to compete, which was $8,448.59. The assignee-taxpayer thereafter began to amortize the sum of $8,448.59 in determining its taxable income. (R. 57-58; Pet. 5a.)

In the small loan business, the typical customer

renews or refinances his outstanding loan approximately 2.6 times, and on the average remains on the books of the loan company as borrower for about 27 to 30 months. Both Royal and Bankers had the experience of obtaining repeat business from former borrowers and referral business from friends of former customers. (R. 55.)

Corporate officers of the taxpayer expected that their corporation would not only earn profit from the businesses purchased (primarily notes and ledger loan accounts), but also additional profit from refinancing and further business with the customers. The taxpayer would not have made either of these purchases from Royal or Bankers if the corporate vendors had not agreed to execute the covenants not to compete, included as a separate provision in each of the contracts of sale. (R. 55-56.)

The Tax Court found that despite the allocation of the separate consideration in excess of that paid for the tangible assets exclusively to the covenant not to compete, the taxpayer purchaser actually and realistically paid that amount both for intangible assets in the nature of good will, or going concern value, which are not subject to amortization, as well as for the covenants not to compete. (R. 58, 61-62.) On the basis of the facts established in the record relevant to the allocation, and applying the principles announced in *Cohan* v. *Commissioner*, 39 F.2d 540 (C.A. 2), the Tax Court allocated, approximately, 50% of the total paid for the intangible assets to good will or going concern value and 50% to the covenants not

to compete.[2] (R. 58, 63.) The Court of Appeals affirmed. (Pet. 1a-7a.)

ARGUMENT

The conclusion of both courts below that the consideration purportedly paid for the covenants not to compete was actually paid for intangible assets in the nature of good will as well as for the covenants is based upon the particular facts of this case and presents no question of general importance. There is no conflict of decisions, or other reason for further review.

1. Taxpayers' assertions (Pet. 8-12) that the decision below is in direct conflict with *Commissioner* v. *Gazette Telegraph Co.*, 209 F.2d 926 (C.A. 10), *Wilson Athletic Goods Mfg. Co.* v. *Commissioner*, 222 F.2d 355 (C.A. 7), and *Ullman* v. *Commissioner*, 264 F.2d 305 (C.A. 2), and with the Government's position in *Rogers* v. *United States*, pending in the Ninth Circuit (No. 16851), are based on the premise that the written contracts in the instant case represent the substance and reality of the transactions. However, the Tax Court found as a fact, on the evidence, that they do not. (R. 58, 61-62.) After analyzing the record, the Court of Appeals affirmed, stating (Pet. 6a):

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[2] Specifically, of the $23,397 paid for the intangible assets in the Royal purchase, the Tax Court found that $11,579.80 was attributable to the covenant not to compete and $11,817.20 was attributable to good will. Of the $4,750 paid for the intangible assets in the Bankers purchase, $3,051.84 was attributable to the covenant not to compete and $1,698.16 was attributable to the intangible assets. (R. 58.)

In this state of the record, we cannot say that the findings of the Tax Court that the extra payment included values in the nature of goodwill or "going concern" values are not supported by substantial evidence or that they are clearly erroneous.

2. The taxpayers erroneously assume that the recitals in the purchase agreement are conclusive as to what portion of the purchase price—an amount admittedly in excess of the value of the tangible assets of the business purchased—was actually paid for nondepreciable good will.[3] "The Tax Court is not bound by the allocation of values made in the purchase contract, and is free to increase or decrease the amounts so allocated in accordance with the facts". *Copperhead Coal Co.* v. *Commissioner*, 272 F. 2d 45, 48 (C.A. 6). "Consequently, it is immaterial whether the contract did or did not define a specified amount as the value of the covenant [not to compete]". *Wilson Athletic Goods Mfg. Co.* v. *Commissioner*, *supra*, p. 357. See also *Particelli* v. *Commissioner*, 212 F. 2d 498, 500 (C.A. 9); *Hamlin's Trust* v. *Commissioner*, 209 F. 2d 761, 764 (C.A. 10); *Masquelette's Estate* v. *Commissioner*, 239 F. 2d 322,

[3] The long standing Treasury Regulations expressly preclude depreciation deductions "in respect of good will", which has an indefinite life. Section 39.23(l)-3 of Treasury Regulations 118, *supra*, p. 3. Good will connotes that portion of the value of a business built up over a number of years which represents the likelihood that the customers dealing with the business in the past will continue to patronize it in the future. *Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436, 446.

325 (C.A. 5). Even the cases upon which taxpayers rely for conflict recognize and reaffirm this settled proposition. The asserted conflict reflects merely a difference in factual situations, rather than any disagreement as to applicable principles. Both courts below applied the established principles to the particular facts of this case; therefore their concurrent finding will not be disturbed. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 51.

3. The record clearly demonstrates, as both courts below found, that the taxpayer purchased intangible assets in the nature of good will as well as covenants not to compete. As the officers of the taxpayer testified, it was expected that their corporation would earn not only profit from the businesses purchased, but also additional profit from refinancing and future business with the customers. (R. 55-56.) Similarly, officials of both sellers testified that each of the sellers, Royal and Bankers, had the experience of obtaining repeat business from former borrowers and referral business from friends of former customers. (R. 33, 36, 55.) In the small loan business, as the taxpayers' own testimony demonstrated and the Tax Court found, the typical customer refinances or renews his outstanding loan approximately 2.6 times, and on the average remains on the books of the loan company as a borrower for about 27 to 30 months. (R. 28-29, 55.) It was further noted by the Tax Court that the taxpayers' records show that, on the basis of experience, this prognosis was quite accurate. (R. 61.) The anticipated turnover, the prospect of

which was substantially and accurately ascertainable from experience, clearly represented a valuable intangible asset of substantial worth—good will or going concern value. On the record presented, the Court of Appeals was thus fully justified in sustaining the Tax Court's conclusion that a part of the separate consideration paid by taxpayers for the intangible assets was allocable to good will.

4. The court below was equally warranted in affirming the Tax Court's determination as to the portions of the extra payment allocable respectively to good will and the covenants not to compete. Specifically noting that it had considered all of the facts established in the record relevant to such allocation, the Tax Court applied its own judgment under the principle of *Cohan* v. *Commissioner*, 39 F.2d 540 (C.A. 2), and allocated, approximately, 50% of the total paid for the intangible assets to good will and 50% to the covenants not to compete. (R. 58, 63.) It is not essential that there be testimony of the specific figure fixed by the Tax Court. *Burford-Toothaker Tractor Co.* v. *Commissioner*, 192 F.2d 633, 635 (C.A. 5), certiorari denied, 343 U.S. 941.

The cases relied upon by the taxpayers (Pet. 14-15) are not controlling or persuasive here. In *Union Stock Farms* v. *Commissioner*, 265 F.2d 712, 724 (C.A. 9), the Court of Appeals remanded for additional hearings because the Tax Court "rejected the only testimony on the subject, and substituted what seemed to him an equitable division". In *Commissioner* v. *Chatsworth Stations, Inc.*, 282 F.2d 132

(C.A. 2), the court properly held that the taxpayer had failed to sustain its burden of proving the purchase and resale prices of the good will of a business.

The approximation necessitated by failure to produce specific evidence should not be set aside unless shown to be clearly erroneous. *O'Dwyer* v. *Commissioner*, 266 F.2d 575, 587-588 (C.A. 4); *McKelvey* v. *Commissioner*, 246 F.2d 609 (C.A. 3). No such showing has here been made. The Court of Appeals found that the approximations in the instant case were not only firmly grounded in the evidence, but pointed out (Pet. 7a) that: "The taxpayers here are the beneficiaries of the Tax Court's leniency in this respect and are in no position to complain".

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

HARRY BAUM,
SHARON L. KING,
Attorneys.

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COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

---

PETITIONERS' REPLY TO GOVERNMENT'S BRIEF IN OPPOSITION

ROBERT ASH
1921 Eye Street, N. W.
Washington 6, D. C.
Attorney for Petitioners

ASH, BAUERSFELD & BURTON
Of Counsel

April 14, 1961

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On April 3, 1961, the Ninth Circuit decided, *per curiam*, *John W. Rogers* and *Creta B. Rogers* v. *United States* which is mentioned in the petition at pages 10-12 and which is in conflict with the case at bar. The Ninth Circuit's per curiam opinion is set forth at page 6 hereof.

The *Rogers* case involved a man and wife who operated a small loan business in Reno. On March 2 1953, the Rogers gave a sixty day option to Acceptance Finance Corporation to sell the entire business, including trade name, office equipment and prepaid rent for $346,398.63. The notes receivable purchased totaled $283,398.69. A five year covenant not to compete was included, but no part of the stated purchase price was allocated to the covenant. On April 13, 1953, the Rogers, at the request of the purchasers, executed a second option which allocated $60,900 to the covenant not to compete. The purchaser amortized the stated cost of the covenant over this five year life of the covenant. The Government contended and prevailed in its position that the $60,900 was severable and should be taxed to the Rogers as the consideration for the covenant. The $60,900 represented the excess paid over the face value of the notes receivable, the value of the office equipment and the prepaid rent.

The Ninth Circuit affirmed the District Court, *per curiam*, even though "The taxpayers probably have been maneuvered by their purchaser into a big tax disadvantage". The Ninth Circuit said that the case of *Hamlin's Trust* v. *Commissioner* (CA 10 1954) 209 F. (2d) 761, 45 AFTR 224 should be followed. The *Hamlin's Trust* case involved a situation where the purchaser agreed to pay $200 per share for the stock in a newspaper corporation. On the day after the sale was agreed upon the purchaser asked if the sellers would object to putting in the contract a statement that $150 a share was being paid for the stock and $50 a share for the covenant not to compete. The sellers agreed. The *Hamlin's Trust* case states the law on the subject, page 765:

> "* * * The contract for the sale of the stock contained a severable provision in which the sellers of stock covenanted not to engage in the newspaper business in a specified area. And it contained separate and distinct provision evaluating the stock and the covenant not to compete, the evaluation being computed on the basis of $150 per share for the stock and $50 per share for the covenant. Thus it is clear that the covenant not to compete was severable; that the parties dealt with it separately; and that the amount received for it was specified and therefore is ascertainable."

In the case at bar the covenant was always treated separately as petitioners' parent corporation would never buy a small loan company without a covenant (R. 24, 42, 46, 55). In the *Rogers* and *Hamlin* cases the separate consideration for the covenant was an afterthought. To say, as the Government says, that in *Rogers* case the covenant was severable, but not severable in the case at bar is to ignore reality and is obviously "clearly erroneous" under *Commissioner* v. *Duberstein* 363 U.S. 278, in which this Court stated page 291:

> "* * * Where the trial has been by a judge without a jury, the judge's findings must stand unless 'clearly erroneous.' Fed. Rules Civ. Proc. 52(a). 'A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.' *United States* v. *United States Gypsum Co.* 333 U.S. 364, 395. The rule itself applies also to factual inferences from undisputed basic facts, id., 394 * * *."

In the case at bar the Tax Court stated "we think that the covenants not to compete were severable"

(R. 62). The cases cited in the petition are based on the covenants being severable.

The Government argues in the brief in opposition that the *Rogers,* and other cases cited, are based on the premise the contracts represent the substance and reality of the transaction, but that in the case at bar the contracts do not represent the substance and reality of the transaction. Any fair reading of the contracts and the testimony shows that in the case at bar the substance and reality were present to a much greater degree than in the *Rogers, Gazette Telegraph Co., Wilson Athletic Goods Co.* (where the contract did not place a value on the covenant), *Ullman* and other cases cited in the petition. The Tax Court in the case at bar did not find that the contracts lacked substance or reality.

The rule that where parties treated a covenant in a separate and severable manner is as well established as any rule in tax law. This Court should grant the petition and state that such is its understanding of the law. Failure to do so will result in many sales not being made, because men simply will not purchase a business or assets unless assured that the seller will not attempt to take the business or assets from him. This in turn will result in less taxes paid to the United States.

At the bottom of page 5 of the brief in opposition it is stated "the Tax Court allocated, pproximately, 50 per cent of the total paid for the intangible assets to good will or going concern value and 50 per cent to the covenants not to compete". The same 50-50 figures are also used on page 9. A footnote on page 6 states that in the Bankers purchase $3,051.84 was attributable

to the covenant and $1,698.16 to the intangible assets. In percentages the figures are 64.2 per cent and 35.8 per cent. In the Royal purchase the percentages were 49.5 and 50.5. The Bankers allocation was much nearer one-third and two-thirds than it was 50-50.

The matter is of importance (1) because this Court is entitled to have the facts correctly stated and (2) it demonstrates that in two substantially similar transactions, except as to amounts, the Tax Court made pure guesses without evidence to support either figure. This is one of the reasons the petition should be granted.

For the reasons stated in the petition and in this reply brief the petition should be granted.

Respectfully submitted,

ROBERT ASH
1921 Eye Street, N. W.
Washington 6, D. C.
Attorney for Petitioners

ASH, BAUERSFELD & BURTON
Of Counsel

April 14, 1961

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 16,831

JOHN W. ROGERS and CRETA B. ROGERS, *Appellants*,

v.

UNITED STATES OF AMERICA, *Appellee*.

Appeal from the United States District Court for the District of Nevada

Before: STEPHENS, CHAMBERS and HAMLEY Circuit Judges.

PER CURIAM:

The judgment of the trial court is affirmed in that its findings on the facts are not clearly erroneous.

The taxpayers probably have been maneuvered by their purchaser into a big tax disadvantage. But, when in their second option, they agreed in writing after negotiation to the assignment of some $60,900 as consideration for a covenant not to compete, the trial court could refuse to go behind the agreement and uphold the commissioner in treating the sum as ordinary income. We find Hamlin's Trust v. Commissioner, 10 Cir., 209 F. 2d 761, pertinent and a case that should be followed here.

Had there been any equivocation or any confusion as to what was done, then taxpayers would have had a far different case. Third parties may question the resolutions of parties to a contract, but in the absence of fraud it is not ordinarily open to the bargainers to do so. Cf. Gray v. Powell, 314 U.S. 402, 414.